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ROOM C-130 04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/84

10:00 a.m., May 19, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
C. H. Dallara	M. K. Bush
	H. G. Schneider
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
	B. Goos
Huang F.	
	Jaafar A.
A. Kafka	H. A. Arias
	M. Foot
	H. Fugmann
M. Massé	
	A. Abdallah
F. L. Nebbia	
Y. A. Nimatallah	
P. Pérez	
H. Ploix	
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

IBRD: M. J. Gillette, Accounting Department. Exchange and Trade Relations Department: J. T. Boorman, S. Kanesa-Thasan. External Relations Department: M. Goldstein, H. O. Hartmann. Legal Department: F. P. Gianviti, Director; J. G. Evans, Jr., Deputy General Counsel; P. L. Francotte, W. E. Holder, A. O. Liuksila, R. Munzberg, J. M. Ogoola, S. A. Silard. Middle Eastern Department: F. Drees, C. Sassanpour. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; J. E. Blalock, D. H. Brown, J. Caskey, J. C. Corr, D. Gupta, B. E. Keuppens, J. A. McLaughlin, D. V. Pritchett, G. Wittich. Office of the Managing Director: R. Noë, Internal Auditor; C. P. McCoy. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: W. R. Bengs, M. B. Chatah, L. P. Ebrill, S. Ganjarerndee, G. D. Hodgson, K. Murakami, G. Nguyen, A. Ouanes, P. Péterfalvy, S. M. Hassan, N. Toé, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, B. Bogdanovic, J. de la Herrán, J. J. Dreizzen, V. Govindarajan, G. K. Hodges, O. Isleifsson, S. King, J. K. Orleans-Lindsay, W. K. Parmena, J. Reddy, L. Tornetta, A. J. Tregilgas, E. L. Walker, B. D. White.

1. PROVISIONING AGAINST LOAN LOSSES IN FUND CONTEXT

The Executive Directors considered a staff paper on provisioning against loan losses in the context of the Fund (EBS/86/82, 4/15/86; Cor. 1, 4/23/86; and Sup. 1, 4/29/86). Executive Directors also had before them a staff paper entitled "Valuation of Assets in the General Resources Account - Provisioning and Write-Off - Legal Considerations" (SM/86/106, 5/16/86).

Mr. Goos noted that SM/86/106 had been circulated on May 16, 1986. The paper was an important one, and Executive Directors and their authorities had not had sufficient time to examine it carefully. Accordingly, the paper should not be formally considered during the present discussion on provisioning.

Mr. Kafka and Mr. Zecchini stated that they agreed with Mr. Goos.

Mr. Dallara remarked that he too agreed with Mr. Goos's request. However, he would wish to pose some questions based on the material provided in SM/86/106.

Mr. Foot remarked that on page 3 of SM/86/106 the staff had noted two cases in which it considered that a loss could occur in the context of the Fund. The staff had not said whether those cases were the only ones in which a loss could occur, or whether those were merely the two clearest relevant cases. Moreover, while the staff had not explicitly said so, SM/86/106 seemed to be based on the assumption that specific provisioning, rather than general provisioning, was appropriate for the Fund.

The Director of the Legal Department said that SM/86/106 examined the problem of provisioning in connection with losses relating to the Fund's holdings of members' currencies, which were claims of the Fund on members. The paper did not address the question of other possible losses--for example, the loss of real property belonging to the Fund, or claims by members or private parties against the Fund in connection with, say, the headquarters building or with actions being brought against the Fund in the event the Fund waived its privileges and immunities. With respect to the holdings of members' currencies, the concept of loss that was examined in SM/86/106 was exhaustive: the two cases that were mentioned were the only such cases of losses provided for under the Articles.

Mr. Dallara noted that on page 2 of SM/86/106 the staff had stated that "there may be cases in which the determination of the SDR rate for a currency is difficult, but it does not mean that the Fund could decide not to determine a rate, or determine a zero rate...." He wondered whether there was not a possible solution between those two extremes, so that the Fund could determine an SDR rate for a currency on the basis of a method that was not used at present and in light of changing circumstances. He also wondered whether the staff was correct in suggesting on page 2 that an existing currency always had a residual value.

In SM/86/106 the staff had referred to a member's obligation to pay an additional amount to the Fund to maintain the value of the Fund's holdings of its currency if the currency had been depreciated, Mr. Dallara remarked. He wondered whether there were any cases in which members had not made the necessary maintenance of value payments to the Fund.

On page 3, Mr. Dallara commented, the staff had stated that "the nonfulfillment of the maintenance of value obligation reduces the value of the Fund's holdings, but it does not reduce the value of the Fund's assets because the Fund has a claim for the difference on the member." That statement seemed to be correct, but he wondered whether the issue raised by that statement was fully settled by the reference to the fact that the Fund had a claim for the difference on the member.

The Director of the Legal Department replied that the staff usually relied on the market in determining the value of a currency. In some cases, there was no significant market for a currency, and it was difficult to determine the appropriate rate. That determination should be an objective one; it should not take the form of a kind of sanction or penalty against a member. Any currency by definition had a value, albeit a very small value in some cases. A currency ceased to have any value only when it disappeared from the market.

The Treasurer commented that some members were overdue in their payments to the Fund to maintain the value of the Fund's holdings of the members' currencies. At least once a year the Fund revalued its currency holdings in accordance with certain Executive Board decisions. Whenever a member's currency was bought or sold it had to be revalued in order to provide equal value for the currency. When the Fund's currency assets were revalued, a claim was established if a member's currency had depreciated against the SDR. If the currency had appreciated, the member had a claim on the Fund, which was obliged to pay the member the excess amount of the currency that the Fund held. Members were obligated to pay their maintenance of value payments promptly at the end of each financial year. As of April 30, 1985, eight members had not made their maintenance of value payments. It was too early to know whether those overdue payments would be prolonged at the end of the current financial year. In practice, members were typically given a month after the end of the financial year in which to make maintenance of value payments; the one-month period met the criterion of promptness. The total amount of overdue maintenance of value payments as of April 30, 1985 was SDR 582 million.

Mr. Goos said that he wondered whether there was a close correlation between members that were overdue in their financial obligations to the Fund and members that had overdue maintenance of value payments.

The Treasurer responded that some--but not all--members with overdue maintenance of value payments also had overdue purchases. It was typically not particularly difficult for a member to provide the Fund with its own currency in order to meet its maintenance of value obligation.

There might be a correlation between overdue maintenance of value payments and members that did not have orderly procedures to discharge any of their financial obligations.

Mr. Dallara said that he wondered whether the overdue maintenance of value payments had any implications for the status of probable losses in the context of the Fund. Could a case be made for provisioning to cover unpaid maintenance of value payments?

The Director of the Legal Department explained that the value of the Fund's assets was not reduced by the nonfulfillment by the member of its maintenance of value obligation because the Fund had a claim on the member for the amount unpaid. However, the risk for the Fund was greater when it held such a claim against a member rather than the member's currency. Hence, the judgment of the need for provisioning was somewhat different in each case.

The Chairman remarked that the expectation of a reconstitution of value seemed different from an expectation to repurchase. Different methods of protecting the Fund in each case might well be appropriate.

The Director of the Legal Department remarked that the problem of an overdue repurchase obligation was different from the problem of the nonfulfillment of the maintenance of value obligation. As the staff understood it, a risk to the Fund would arise only in connection with a member's withdrawal; in that event, it would be more difficult for the Fund to collect its claims on the member than it would be to sell the Fund's holdings of the member's currency.

Commenting on the question whether or not each currency had a residual value, the Director of the Legal Department said that even the currency of a member that was ineligible to use the Fund's resources had some value in the local marketplace for small transactions in foreign currency. However, if the Fund were to announce that it planned to sell its holdings of that country's currency in order to raise a sum equivalent to the amount of the member's overdue financial obligations to the Fund, the Fund's holdings of that currency could become effectively worthless. He wondered whether the Fund's external auditors had ever raised that issue.

The Treasurer remarked that the external auditors had considered the question whether certain currency holdings of the Fund had value and what the value should be. The auditors had also raised the question what the value of a currency would be when it was clear that the Fund wished to liquidate its holdings of that currency. The staff had replied by noting that the Fund determined the value at which it accounted for a member's currency on the basis of rules established by the Executive Board. According to those rules, if there were a market rate for the currency against the U.S. dollar, the rate for valuation purposes would be the SDR rate of the U.S. dollar against the currency concerned. If that rate did not exist, the appropriate rate would be the cost of another currency against the currency of the country concerned. If none of those rates were available, the Fund would determine the rate. Such determinations had to be made from time to time. In those events, the Fund had considered any other available rates; in some cases black market rates were known or there had been several official rates for the same currency. The general principle was that an exchange rate was determined accepted by the Fund after consultation with the member to determine the SDR value of the Fund's currency holdings of the member. These rates were determined by the Fund in keeping with its Articles and were on the books of the Fund.

The External Auditors had not been fully satisfied with that answer, as there was still the question of how the Fund should value its holdings of the currency of a member that had not met its repurchase obligations, the Treasurer went on. In the staff's view, which was consistent with the Articles, there was no distinction between currency holdings: all must be valued according to the same principle; and there was only one exchange rate for each currency. The auditors had further asked whether the Fund would assume that the market rate that was determined by the Fund would reflect the value of the currency at the time that the Fund intended to sell the currency. The Fund could not sell a member's currency in the market without the cooperation of the member. The Fund had the authority to sell a member's currency after the member's withdrawal from the Fund. If a member withdrew and did not meet all its obligations to the Fund, the Fund was entitled to sell that member's currency in the market and to determine the real value of that currency. The valuation could involve a profit or a loss for the Fund. The rate determined by the Fund would not be the market rate strictly speaking but would be derived from the market and might be higher or lower than the rate that would be obtained from an actual sale of the currency concerned. He agreed with Mr. Foot that, if the Fund were to sell a large amount of a member's currency in order to offset the member's overdue obligations to the Fund, the market price for the currency concerned could drop. That development would suggest that the value of the currency had been excessively high.

There was, however, an unresolved issue that should be borne in mind, the Treasurer said: the Fund did not have private balances of the currency of a member; the Fund's holdings of a member's currencies were in the central bank or depository of each country and were controlled by the member. Unless the member cooperated and transferred its currency to another member, the sale of the currency that was desired by the Fund could not take place. In theory the Fund could test whether a currency had a residual value by trying to sell the currency in question. Presumably a member that was in arrears to the Fund would not comply with the Fund's instructions for a sale; therefore, in the context of the Fund, there would be no market for that currency. The staff did not recommend that the Fund should conduct such a test, which might show that a member's currency had no value.

Mr. Nimatallah remarked that the book value of the Fund's holdings of a member's currency might differ significantly from the market value. A test of a currency's value through the sale of the Fund's holdings of that currency might yield unpleasant results for both the Fund and the member concerned. The Fund's resources need not have the same actual value as the value that they were given in the Fund's books. Accordingly, the Fund needed to have a more comprehensive way in which to determine whether or not a probable loss was likely to occur. The fundamental issue at hand was the difference between the book and market value of the Fund's holdings of members' currencies. That issue ideally should have been explored well before the present discussion and was not dealt with in SM/86/106. He was worried that, given the late distribution of SM/86/106, the present important discussion would fail to clarify significant legal and practical issues.

Mr. Fujino considered that the issues the Treasurer had discussed had to do with illiquidity rather than the maintenance of value. He wondered whether there were any protracted overdue maintenance of value payments.

The Treasurer said that the current financial year was the first one in which overdue maintenance of value payments had persisted more than one or two months.

The Chairman remarked that the trend in overdue maintenance of value payments was puzzling. After all, it was not particularly difficult for a member to maintain the local currency value of the Fund's holdings of the member's currency. The Fund should act forcefully to reverse the trend.

Mr. Nimatallah noted that on the bottom of page 3 the staff had remarked that if the Fund determined that there was a probability that a loss could arise in connection with the withdrawal of a member, for instance, because the member had expressly repudiated all its obligations to the Fund, provision could be made for that risk even before the effective date of the withdrawal of the member. He wondered how soon before the withdrawal provision could be made.

The Director of the Legal Department remarked that there was no specific limitation on when the Fund could act to make provision against a risk before the effective date of withdrawal of a member. However, the decision on the provision would have to be linked specifically to the withdrawal of the member. There was a difference between possible and probable losses. Provisioning was intended to cover probable loss. Reserves were available to cover possible losses.

The Treasurer added that if the Executive Board, the Managing Director, or the Treasurer--who signed the Fund's financial statements together with the Managing Director--were to conclude that a loss was likely to occur, the Fund had no choice under generally accepted accounting principles but to make provision against the loss. The issue at hand was when the Executive Board could reach that conclusion--and specifically whether such a conclusion could be reached in the absence of a declared intention by a member to withdraw from the Fund or in the absence of a declaration by the Executive Board that the member should be compelled to withdraw. In his view, the Fund could reach such a conclusion before the event.

Mr. Polak said that he wondered whether the Fund was entitled under the Articles to provide debt relief to a member that, in the Fund's judgment, could not repay its debt to the Fund.

The Director of the Legal Department responded that the Fund had no power to relieve a member of its obligations to the institution. The Fund was empowered to reschedule a member's obligations to the Fund. However, rescheduling would merely postpone the required payment of the obligation; it would not eliminate the obligation itself.

Mr. Sengupta remarked that rescheduling was a form of partial debt relief.

Responding to a question, the Director of the Legal Department said that the Fund was empowered to return an amount of charges that had been paid by a member. The Fund could, by a general decision, applicable to all members, reduce the rate of charge retroactively for all or part of a financial year until it had made its final decision on the calculation and allocation of net income for that year. There was a difference, however, between a decision cancelling a member's obligation that had arisen out of a prior decision (e.g., on charges) and a decision relieving a member of an obligation imposed by the Articles (e.g., on repurchases). The Fund could take the former, not the latter.

Mr. Nimatallah considered that it was crucial to examine the difference between possible and probable loss. He wondered whether the staff had meant to suggest that the Executive Board should be left on its own to decide when the provisioning should be provided for with the exception of a declaration of withdrawal, in which event provisioning would automatically be provided for. Should there be any other criteria for considering when a probable loss would occur?

The Director of the Legal Department replied that it was up to the Executive Board to decide that a loss was probable. The decision was a matter of judgment. There were no specific criteria to meet, other than the connection with a declaration of withdrawal.

Mr. Sengupta said that he had taken the Treasurer to mean that the difference between probable and possible loss was not particularly relevant to the present discussion. It would be up to the Executive Board to take a view on the need for provisioning in a particular case involving an imminent probable loss.

Mr. Alfidja noted that on page 26 of EBS/86/82 the staff had explained that the External Audit Committee had told the Managing Director that the Treasurer's Department was in the process of establishing a more comprehensive and structured approach to the evaluation of whether or not a material loss was probable with respect to a member with protracted obligations to the Fund. A further comment on that issue would be helpful.

The Treasurer noted that the External Auditors had not set a deadline for establishing a new approach, but the staff expected that the next group of external auditors would inquire whether there was a procedure in the Fund under which a judgment was reached whether or not a loss was possible or probable. The staff would reply that it had prepared papers for consideration by the Executive Board, which was examining the matter carefully. The auditors would not have a view on whether or not the Fund faced a probable loss. However, the auditors would feel that it was incumbent on the managers of all institutions to follow generally accepted accounting principles and to reach a conclusion on whether or not a loan loss was probable.

The Chairman recalled that the External Auditors had repeatedly stressed the importance of the fundamental accounting principle that there were two basic prerequisites for provisioning: the institution had to reach a judgment on the probability of a loss; and the institution had to reach a judgment on the amounts that should be provisioned in the context of the probable loss.

Mr. Sengupta said that he wondered whether the Fund could conclude that a loss was likely to occur even before a member had repudiated its obligations to the Fund.

The Director of the Legal Department responded that SM/86/106 included an example of circumstances in which the Executive Board could conclude that there was a probability of a loss. Other circumstances--not involving an express repudiation of a member's obligation under the Articles--could occur.

Mr. Massé said that if a central bank refused to exchange its currency, the actual value to the Fund of the Fund's holdings of the currency of the country would be zero. Presumably that situation was one in which the Fund could take a write-off. As he understood it, the final paragraph on page 3 said that the Fund would have to determine that a loss was probable and a provision to cover it was needed when a member had repudiated its obligations to the Fund or there was a probability that the member would withdraw from the Fund. The Fund could not determine that there was a probability of a loss unless the member concerned intended to withdraw from the Fund.

The Director of the Legal Department stated that the Articles provided that a loss could be considered in connection with a withdrawal from membership. Therefore, provisioning could be made when the Executive Board had concluded that a loss in connection with the withdrawal was probable.

Responding to a further question, the Director of the Legal Department said that, in the absence of actual withdrawal, provisioning could be made if there was a probability of a withdrawal by a member.

The Chairman remarked that there seemed to be conflicting requirements: the External Auditors had stressed that provisioning should be introduced when a loss was probable and the amount of the loss could be reasonably estimated; the Articles seemed to require that provisioning had to be linked with a withdrawal by a member.

The Treasurer said that the External Audit Committee might wish to study SM/86/106 in considering the Fund's provisioning needs. In judging the probability of loss the Fund would not judge the probability of withdrawal. He doubted whether the Executive Board would actually take a position on the question of the probability of withdrawal by a member. The Executive Board would have to take a position on the probability of loss in connection with the member.

Mr. Massé considered that the Articles did not limit provisioning only to losses that were related to withdrawal by a member. In the second paragraph on page 2 of SM/86/106, the staff had noted that the Fund's holdings of a currency could not be written off--i.e., accounted for below the SDR rate--even when the member was in arrears. In the third paragraph on page 2 the staff had indicated that there might be cases in which the determination of the SDR rate for a currency would not be made either in accordance with the market or on the assumption that the Fund would be repaid by a member with overdue obligations. A central bank could refuse to engage in an exchange of currency, in which event the proper SDR valuation of the currency might be zero. That valuation would raise the possibility of the need for a write-off.

Mr. Polak remarked that the definition of "loss" under the Articles seemed to be narrow. However, he doubted whether that was the main issue at hand. The main interest of the Fund was not whether or not a member withdrew, but whether it repudiated its obligations to the Fund and the institution was able to regain the resources that it had made available to the member. If a member declared that it did not intend to make scheduled repurchases, the Fund would have suffered a loss for operational purposes as the Fund's ability to conduct its operations would have been reduced. Provisioning in the event of such cases would be fully appropriate.

The Chairman said that the staff had shown that a clear link existed between the concept of withdrawal and the concept of loss in the context of the Fund. Accordingly, the Fund might have to make provision for cases in which it was likely that it would not be repaid by establishing a special reserve. One of the main issues at hand was how to respond when it had become clear that a member would not repay the Fund. That possibility should not be examined solely in the light of withdrawal.

Mr. Nimatallah considered that the issues at hand were straightforward: when the resources of the Fund were reduced because a member did not repay the Fund over a long period, the membership must assume the responsibility to provide an equivalent amount of resources to enable the Fund to continue to help other members by maintaining the revolving nature of the Fund's resources. The Fund should not wait until the member concerned was likely to withdraw from the Fund before the Fund acted to cover the lost resources.

The Chairman said that he agreed with Mr. Nimatallah. The staff had not meant to say that the Executive Board should be inactive until the probability of a withdrawal triggered the provisioning procedures. The staff had said that the Fund could not recoup resources that a member country was unwilling to repay. To cope with such situations the Fund could choose to build up its reserves rather than utilize provisioning arrangements.

Mr. Goos commented that he agreed that on a strictly legal basis the risk of a member's withdrawal was the only occasion that would give rise to provisioning. But the Treasurer had pointed to other considerations pertaining to the ability of the Fund to use its currency holdings. In some situations, the Fund might not be able to sell its holdings of a member's currency because the member was unable to provide the necessary foreign exchange. Such situations would extend beyond the cases of withdrawal and the group of countries that were overdue in their financial obligations to the Fund. Accordingly, if the usability of the Fund's currency holdings were introduced as the criterion for provisioning, the Fund might be required to change the valuation of its holdings in a fundamental way. He therefore cautioned against such an approach.

The Treasurer said that in EBS/86/82 the staff had concluded that provisioning was necessary if the conclusion was reached that a loss was probable. The staff had not said that such a conclusion must be reached in certain circumstances. The staff had noted that if the Fund's liquidity was impaired because the Fund was not repaid on schedule, an alternative to reaching a conclusion that a loan loss was probable would be to strengthen the Fund's reserves.

It was important to distinguish clearly between provisioning and writing off, the Treasurer continued: an asset was written off only after it had been actually lost--it could not be written off in advance; provisioning was made against possible loss. He agreed with Mr. Goos that a basic problem was deciding whether or not a loss existed under the valuation provision. As speakers had noted, such a loss would occur in the event of an illiquid currency whose value was zero; in that situation, the Fund would have to register a loss. In that connection, as Mr. Massé had noted, a loophole existed: if it was agreed that a currency was totally illiquid and could not be used, its value must be zero and the currency should be written off. Writing off a currency would have substantial implications for the Fund's operations, and the staff did not recommend that action.

Mr. Fujino commented that, while there was a need for a structured approach to provisioning, the Fund was a unique institution to which the usual accounting principles did not always fully apply. In his view, provisioning in narrow, accounting terms was closely related to writing off. If there was no need to write off an asset, there would be no need for provisioning in a strict accounting sense.

Mr. Nimatallah considered it as unnecessary to write something off in order to use the provisioning mechanism. The Fund could provision against a probable loss but retain the relevant assets, whose value could conceivably be strengthened eventually. When an institution was convinced that an asset's value had fallen to zero, it could write the provision off, thereby ceasing to hold the asset any longer. Under provisioning, the institution increased its liabilities through the provisioning but did not experience a corresponding reduction in its assets.

Mr. Rye said that, as he understood it, the Fund would have to look at each case of possible loss, rather than the aggregate of possible cases. For example, if there were ten cases in which there was a 10 percent chance of loss in each case, there would be a better than even chance that at least one of those cases would involve a loss; in other words, there would be an overall probability of loss that could not be connected ex ante to any particular case.

The Director of the Legal Department explained that the staff had had in mind the probability of loss in individual cases.

The Chairman remarked that there might well be a need for an internal, structured approach toward possible and probable losses. The Fund should be ready to act in the event that it judged that a loss was likely to occur. The Fund could conceivably respond through the use of provisioning or by a building up of reserves. The Fund could begin its assessment of possible loss by considering individual cases; it could also arrive at a global notion of probable loss to which it should be prepared to respond.

Mr. Sengupta noted that the Executive Board had consistently favored taking action in response to members' overdue financial obligations to the Fund. The Fund's resources must remain revolving, and the Fund should make every possible effort to ensure that it would be repaid. The Fund had already taken a number of steps in that direction, and the question of building reserves could be discussed further, if necessary. However, the concept of loss was crucial in the consideration of provisioning. A loss occurred only if there was a write-off of asset holdings. The Fund could introduce provisioning in response to a probable loss, but the mechanism should be employed only after an asset had been written off, and that situation would arise only in the context of withdrawal by a member from the Fund. Accordingly, provisioning was not an appropriate response to overdue obligations to the Fund. As Mr. Fujino had stressed, normal accounting principles were not fully applicable to the Fund.

Mr. Nimatallah said that the question whether or not normal accounting theory and practice applied to the Fund was a separate matter. Under normal accounting practice, an asset need not be written off before provisioning was introduced; provisioning was meant to make allowance for a possible loss. If the loss did not actually occur, the Fund would retain the assets in question. However, when the Fund was certain that it would not be repaid, the relevant assets would be written off. Under normal practice, provisioning was introduced when an institution doubted whether a loan would be repaid.

The Treasurer remarked that he agreed with Mr. Nimatallah that the Fund could implement provisioning without writing off an asset. The Fund could legally sustain a loss on repurchase obligations by a member; the Fund would sustain a loss if it sold the member's currency on the market for an amount that was less than the value of the currency on the Fund's books. The Executive Board could reach a conclusion that such a loss was probable. In that event, the Board--acting consistently with general accounting principles--should make a provision for that probable loss. A provision was introduced in order to cover possible write-offs.

Mr. Sengupta commented that he agreed that the Fund could introduce provisioning before a write off took place. However, there should be a probability that a write-off would occur before provisioning was introduced, and in the Fund it was difficult to conclude that a loss was likely to occur in the absence of a declaration by a member of its withdrawal from the Fund. The Executive Board must take steps to ensure the liquidity of the Fund, but provisioning was not an appropriate step for the Fund. The discussion on the options for dealing with possible losses should center on burden sharing and building reserves.

Mr. Dallara said that he hoped that progress could be made at the present meeting in clarifying both the need for and possible approaches to provisioning in the Fund. However, in the light of the financial and legal complexities surrounding the issue, he was not in the position at the present stage to express definitive views on all aspects of the issue. Further staff work would be needed in the light of the present discussion in order to enable Executive Directors to develop more definitive views that could be discussed at a later stage, perhaps in late June or early July 1986.

During the present discussion it was useful to keep in mind the latest six-monthly report on overdue financial obligations to the Fund (EBS/86/98, 4/28/86), Mr. Dallara remarked. Indeed, that report provided a sobering backdrop to the present consideration of provisioning: it painted a more unfavorable picture of overdue obligations in comparison with the situation in November 1985, despite the recent settlement of large overdue obligations. The deterioration reported by the staff underscored the need for all members to intensify their efforts to help solve arrears problems by addressing the underlying difficulties, as Mr. Salehkhou had stressed during previous reviews of the Fund's arrears problems. The report also underscored the need for the Fund to take the necessary steps to protect its financial position in recognition of the increasing seriousness of the arrears problems.

The staff had proposed to establish a more comprehensive and structured approach to the evaluation of the question whether or not a material loss was probable with respect to members with protracted overdue obligations to the Fund, Mr. Dallara noted. He would not address that point in detail at the present meeting, as he had reviewed it during the previous discussion on provisioning. However, some aspects of the issue warranted additional stress. The Treasurer's Department had informed the external auditors nearly a year previously that the Fund was in the process of establishing the more comprehensive and structured approach that the staff had proposed in EBS/86/82. He agreed that it was incumbent on the Fund to establish process for determining the circumstances in which a loss might be considered probable. The approach should be a structured one involving agreed criteria on which to base a judgment of probable loss. It was his clear impression that an ad hoc approach would be insufficient to meet the needs that had been noted by the Treasurer and the External Audit Committee.

In considering possible approaches to reaching a judgment on probable loss, Executive Directors must bear in mind that the Fund was not like any other financial institution, Mr. Dallara continued. The Fund was a unique institution with a unique financial structure. It was a cooperative institution in which all members had rights and obligations. In a technical sense, the Fund did not make loans; the Fund exchanged one asset for another. Moreover, the Fund did not have commercial customers; it exchanged assets with sovereign nations that were members of what was in effect a cooperative. The Fund did not arrange loan contracts; it had articles of agreement, by-laws, rules and regulations, and stand-by and extended arrangements.

Given those unique characteristics, it was clear that the Fund's analytical and operational tasks were particularly difficult, Mr. Dallara went on. However, it was the responsibility of members and the Executive Board to take the steps that were necessary to protect the real and apparent financial strength of the Fund. The labyrinth of complex policy and legal questions that arose because of the issue of provisioning was daunting but should not divert attention from the fact that the Fund extended credit in hard currencies. There was some risk in extending that credit relating to the ability of some members to meet their hard currency obligations on a timely basis, the risk had become greater in the recent past--as evidenced by the experience with overdue obligations--and a financial loss by the Fund was legally and actually possible. Such losses were not supposed to occur in a cooperative institution like the

Fund, but the possibility of losses was a reflection of certain aspects of the current overall situation in the Fund and in members. The challenge facing the Executive Board was to take prudent steps to protect the Fund's financial position that were consistent with the unique characteristics of the Fund. Meeting that challenge would involve adhering in an appropriate fashion to generally accepted accounting standards that, as the Chairman had reaffirmed, were applicable to the Fund.

The most difficult aspect of the issues at hand was to determine the circumstances in which the Fund might incur a loss, Mr. Dallara remarked. SM/86/106 had shed some light on that matter. However, he still felt uncertain about one fundamental point. Everyone would agree that a loss could occur when a member withdrew from the Fund either compulsorily or voluntarily and did not repurchase the Fund's excess holdings of that member's currency. However, it was not clear to him whether there were other circumstances in which the Fund might incur a loss. He wondered whether the Executive Board might reach a judgment that, in particular circumstances, a procedure other than the usual one for determining the SDR rate of a currency might be warranted. The precise nature of the circumstances under which such a judgment would be appropriate was not immediately evident, but there might be circumstances in which the Fund could reach a judgment that a loss was probable. That approach would leave open the possibility that there could be a situation in which a loss could occur that was not necessarily associated with a member's withdrawal from the Fund.

Another difficult question was how much weight the Fund should give to the current and prospective practices of other institutions, Mr. Dallara said. EBS/86/82 included a useful appendix on commercial bank practices and information on the practices of other multilateral institutions. The Executive Board needed to have a better understanding of the financial differences between the Fund and other institutions, particularly the World Bank, and of how relevant those differences were for the issues at hand. Certain differences between the financial structure and operation of the Fund and the World Bank were potentially relevant, but others seemed to be irrelevant.

The World Bank's decision to adopt provisioning had apparently been driven by the institution's relationship to its financial markets, Mr. Dallara commented. The Fund also had a special market, namely, its member governments. That market was obviously very different from the private market, and its participants had very different and broader interests than the private market. At the same time, the Executive Directors should not assume that official shareholders--including his authorities--were any less interested in prudent financial management than were private investors.

Although further work by the staff was required, there was a clear need for a more structured approach to evaluating whether a loss was probable, Mr. Dallara continued. Consideration should be given to the following approach: after a member had been in arrears on repurchase obligations for a specified period--perhaps 18 or 24 months--it would be presumed that some loss would be probable and that provisioning would therefore be needed. A provision under that approach would automatically be made for a certain percentage--perhaps 15 percent--of the member's total outstanding obligations to the Fund. That provision would be an initial one; similar amounts would be provisioned for on an annual basis as needed.

That approach was similar to the one that was described on page 14 of EBS/86/82, Mr. Dallara went on. It was not fully clear to him that the staff was recommending the approach mentioned on page 14, where the staff had stated that "in this regard, consideration may be given in coming to a conclusion as to the probability of loss if repurchase and other payment obligations to the Fund were overdue by, say, three years or more." The time-frame of the staff's approach was different from the approach that he himself had suggested.

His approach would be automatic and would involve a simple formula based on one criterion, Mr. Dallara said. A mechanism that stressed simplicity and automaticity would be desirable partly because it could enable the Executive Directors to avoid difficult meetings to reach judgments on probable loss. It could be argued that some flexibility in judgment would be helpful. Accordingly, the approach that he had suggested could be modified by retaining the presumption that some loss would be probable after a specified period while permitting management to take into account possible mitigating factors, such as the member's economic policies and programs as well as the prospects for improvement in the country's balance of payments. If in management's view such factors argued against the automatic application of the formula, management could recommend to the Executive Board to refrain from introducing provisioning, adding perhaps that the matter should be reviewed after a specified interval. Some Executive Directors might feel that that modification would add excessive judgment to the process of provisioning. However, the time-frame would still be the key criterion.

Under the approach that he favored--with or without the modification that he had described--the Fund's financial statement could show an amount provisioned, perhaps labeled as an "allowance for loss on credit extended," but there need be no reference to specific countries involved in the notes to the financial statement, Mr. Dallara remarked. Further guidance from the staff on such technical matters would be required. Moreover, he looked forward to hearing the views of other Executive Directors, management, and staff on the amounts that could be provisioned each year and other technical aspects of implementing a system of provisioning like the one he had described, which was only one possible structured approach to evaluating the probability of loss.

An important question concerning provisioning was how to deal with the associated costs, Mr. Dallara said. His authorities were prepared to give further consideration to that question, and the staff had outlined a possible approach to handling costs related to overdue payments in EBS/86/81 (4/14/86). That approach was interesting and merited further analysis. Although that approach had been suggested in the context of the costs of the practice of nonaccrual, a similar approach could be applied to the costs of provisioning as well. However, certain aspects of the staff's proposal went considerably beyond what his authorities would be willing to support, such as the idea that the remuneration coefficient could be reduced as low as 80 percent of the SDR interest rate. However, the suggestion to use a five-year SDR rate plus 50 basis points merited further consideration. He was prepared to return to the issue in the near future, taking into account the full range of factors that he had mentioned during the discussion on April 30, 1986, including the effective rate of remuneration.

While other Executive Directors shared his concern about the need for the Fund to take prudential steps, some of them seemed to be inclined to increase the general reserves rather than to establish provisions, Mr. Dallara commented. Reserves might be able to provide similar protection against loss from overdue obligations, but he was not convinced that increasing reserves was the most appropriate response to the problems posed by overdue obligations. Increasing reserves might not meet the criterion of a more structured approach to evaluating probable loss. An increase in general reserves would not be a specific acknowledgment of the existence of a probable loss. For other reasons as well reserves might not be an adequate substitute for provisions. An increase in reserves could overstate the net equity of the Fund and the amount of available resources. A related question was the adequacy of the Fund's reserves. Although arrears had been growing, the reserves had grown very modestly; there were only SDR 27 million more in reserves at present than two years previously, when the arrears problem had been much smaller. Further attention to the adequacy of the Fund's reserves and to the possible need for an increase in reserves would be welcome.

The Treasurer, responding to a question, said that overdue repurchases from members that were late in payments to the Fund for two years or more amounted to about SDR 50 million at the end of the financial year. The amount that had been outstanding from members overdue for more than three years--which was attributable to only one country--was SDR 19 million.

Mr. Fugmann said that he wondered whether the period of 18-24 months that Mr. Dallara had mentioned would begin with a declaration of ineligibility to use the Fund's resources.

Mr. Dallara commented that there need not be a direct relationship between the 18-24 month time period that he had mentioned and the declaration of ineligibility. However, the existence or absence of a declaration of ineligibility could be one of the factors that was taken into account by staff and management in judging whether provisioning was required in a particular case.

The Chairman said that he wondered whether, under Mr. Dallara's proposal, provisioning would cover a member's total outstanding obligations to the Fund or the obligations that had been outstanding for the 18-24 month period that Mr. Dallara had mentioned.

Mr. Dallara replied that the provision would be for a certain percentage--perhaps a relatively low percentage initially--of total outstanding repurchase obligations of a member that had been overdue beyond a certain period on the assumption that the repayment of those obligations was in doubt. On the basis of the 15 percent criterion that he had mentioned, provision would have to be made for about SDR 14 million to cover obligations that had been overdue for two years. However, as of October 1986, the amount to be provisioned would exceed SDR 100 million if Sudan's arrears had not been eliminated by that time.

Responding to a further question, Mr. Dallara said that he recognized that various approaches to provisioning on the basis of his proposal were possible. The staff should examine the possibility of applying a particular formula on the basis of a specified time period. It could be argued that a probability of loss was related not only to obligations that were already overdue, but to obligations that might become overdue. Alternatively, a system of provisioning could be limited to obligations that were overdue beyond a certain period. In that connection, the practices of other institutions varied. However, if the system were limited to obligations that were overdue within a specific period, the percentage of that amount that would be covered by provisioning should be high, perhaps 100 percent.

Mr. Nimatallah commented that a system of provisioning could cover either the amounts of a member's overdue obligations for a certain period--say, two or three years--the total overdue obligations of the member, or the total outstanding obligations of the member, including its overdue payments. There could be a direct relationship between the ratio that was chosen for the provisioning formula and the particular coverage of the arrears among the three options that he had mentioned. In assessing the probability of loss, commercial institutions usually looked at a borrower's overall position even if they were concerned only about certain aspects of that position. One of the issues at hand was whether the Fund should take into account all of a member's outstanding obligations to the Fund as soon as some of the member's obligations had become overdue for a specified period, say, two or three years. Alternatively, the provisioning system could be concentrated on obligations that had been overdue beyond the specified period. In his view, provisioning should cover amounts that had been overdue for the specified period. Moreover, the provisioning should cover 100 percent of the amount concerned. The amounts involved would be fairly small and might well disappear over time, and the approach that he favored would give the Fund some flexibility, as the same provision could be applied to an amount that was overdue for two or three years. The provisioning system should not make a member feel that it was being discredited by the Fund.

The staff representative from the World Bank remarked that the World Bank had not yet adopted a policy of provisioning against loan losses. That matter would be discussed by the Executive Board on May 20, 1986. At present, the intention--which had been discussed with the Joint Audit Committee--was to adopt a so-called normative rate of provision for any borrower whose loans were in arrears for more than two years. Accordingly, the provisioning would initially cover one fifth of the member's total outstanding obligations, and in each of the subsequent years an additional one fifth would be covered unless there were a compelling reason to apply a higher percentage. The definition of that compelling reason had not yet been agreed, but it would of course be based on conditions in the economy concerned and on the World Bank's assessment of the imminence of probable loss.

As to the issue of provisioning against part or all of the World Bank's portfolio holding with respect to a particular member, it was helpful to bear in mind the fact that in most cases the borrower that was in arrears to the World Bank was a government, and that the World Bank was unable to distinguish among its assets the differential probabilities of loss for those assets, the staff representative from the World Bank commented. There could be an exception to that general conclusion, as so-called enclave-type projects involved a number of guarantors in addition to the government and the assets involved were clearly distinct from the government's general assets. An example of such a case would be a mining operation in a poor country that normally was not eligible for World Bank lending; it was conceivable that, with the failure of that project and the refusal by the private sector or outside government guarantors to meet their obligations, the World Bank might distinguish that particular loan from other loans to the government concerned.

Responding to a question, the staff representative from the World Bank said that, as an example, if a member were two years in arrears on $100 million of outstanding obligations to the World Bank, the institution would provision $20 million of the $100 million in the first year of the five-year provisioning period and the same amount in each of the next four years of that period. Accordingly, over the five-year period the World Bank would have provisioned against the full amount that had been outstanding at the time that the provisioning had been introduced. During that period, it would be unlikely that the World Bank would make new loans to the member concerned or that the institution would continue to disperse credit under an outstanding credit agreement with the member.

Mr. Zecchini remarked that he took the staff representative from the World Bank to mean that under the World Bank's proposal, that institution would in effect be provisioning against the debtor country as a whole and not against specific overdue obligations of the member. In other words, the World Bank would be assessing the ability of the country to repay all its overdue obligations and not merely the specific obligations that had been overdue for a certain period.

The staff representative from the World Bank said that Mr. Zecchini's understanding was correct.

Mr. Abdallah remarked that provisioning was likely to have a number of implications for the Fund's operations. The Fund was not a profit-making institution, and issues concerning its income and probable losses were of secondary importance in comparison to the Fund's main role of helping members to meet balance of payments needs. That function was crucial during a global recession--such as the one from which the industrial countries had just emerged--or during periods of widespread liquidity problems such as those facing a number of low-income countries. The deepening liquidity and debt problem facing those countries continued to be a feature of the tight conditions in those countries and made it difficult for them to remain current in their payments to the Fund.

As he understood it, Mr. Abdallah went on, provisioning in the context of the Fund would have two purposes: to present a fair statement of the assets of the Fund--including their expected realizable value--by indicating and provisioning for outstanding repurchases that might not be made and to guard against an overstatement of the Fund's income in any fiscal year.

Before introducing any provision against overdue repurchases the Fund must consider whether it was probable that a country would repudiate its obligations to the Fund, Mr. Abdallah said. Such repudiation had never occurred. The staff had mentioned that the possibility of repudiation could not be ruled out, but, in his view, the probability of repudiation was very small and was no more likely to occur at the present stage than at any time in the past. Accordingly, there seemed to be no need to introduce provisioning at the present stage.

A member's ability to repay the Fund should be assessed, taking into account the duration of the member's overdue obligations, Mr. Abdallah went on. However, such a consideration would not establish a convincing case in favor of provisioning, since all Fund credit was fully covered by collateral in the form of the Fund's holdings of each member's currency. In the absence of an indication that a member was unwilling to honor its obligations to the Fund or that the country intended to repudiate its debt to the Fund, a case for provisioning could not be established solely on the basis of the duration of the overdue payment of a fully-secured debt. Moreover, the Fund's credit was extended in the form of sovereign lending to countries, Mr. Abdallah remarked. As the staff had noted, no other intergovernmental financial institution had introduced provisions against sovereign debt, although the World Bank was moving in that direction at the encouragement of some members. However, the World Bank was not a model for the Fund to emulate in the area of provisioning; the Fund was a unique institution.

The introduction of provisioning in the Fund would require the Fund to institute the practice of evaluating the creditworthiness of all members in order to decide which member's obligations were substandard and nonrecoverable, Mr. Abdallah commented. That practice could have serious implications for the Fund and would not help the members that were facing payments problems. In fact, the practice could send a signal to the rest of the financial community that it should refrain from lending to the members concerned. A conclusion by the Fund that a member's loans from the Fund were uncollectable might send a signal that the member did not have to repay the loans in the near future because the Fund no longer counted on receiving payment from the country.

The Fund had always been able to avoid overstating its current income without resorting to provisioning, Mr. Abdallah remarked. As the staff had noted on pages 8-9 of EBS/86/82, a series of steps had been taken since early 1985 with a view to maintaining an adequate income position for the Fund: in March 1985, the Executive Board had decided to exclude from current income unpaid charges due from members that were overdue for six months or more; in June 1985, the Fund had raised the net income target from 3 percent to 5 percent of reserves; in December 1985, the Fund had decided to introduce effective February 1986 special charges to recover certain costs arising from overdue payments; and the Fund had also decided in December 1985 to raise the rate of charge from 7 percent to 7.87 percent. Moreover, the Executive Board was considering further refinements in the handling of the implications for the Fund's income of overdue charges, especially the possible introduction of retroactive surcharges on the rate of charge and discounts on the rate of remuneration. As a result of those steps, the Fund's financial position was adequate and new steps, such as provisioning, were not required at the present stage.

The discussion of the legal considerations concerning provisioning in SM/86/106 placed the issue of provisioning in a new perspective, Mr. Abdallah considered. He was therefore pleased that the Executive Directors decided to give themselves and their authorities more time to study the paper. After all, the Articles represented an international treaty that was binding on all members. Moreover, the Articles were part of the domestic law of members, and interpretations of important Articles, such as those covering possible losses by the Fund, concerned all members for several reasons in addition to financial ones. He did not agree that the accounting principles and conventions of any one member or even of all accounting organizations should override the relevant provisions of the Articles. The Fund must do what it was authorized and empowered to do, not what accounting conventions suggested were appropriate or advisable in a context that was in any event not relevant to the Fund's operations. The staff's discussion of provisioning in EBS/86/82 should be revised in the light of the legal considerations mentioned in SM/86/106.

The Treasurer, responding to a question by Mr. Nimatallah, said that if a provision were established, its counterpart would be an expense item that would be included among all the Fund's other expenses. If the Fund wished to recover that particular expense, it should add a corresponding amount to its income or should reduce its other expenses by a corresponding amount. If the Fund reduced its expenses by the needed amount, it would not reduce its assets in the process. If the Fund were to increase its income to cover the provision, the Fund would receive SDRs that it would add to its holdings and which could be used in the Fund's operations in the normal course of events.

Mr. Nimatallah commented that the additional income could be used to finance an arrangement with a member. In other words, the provisioning would be helpful to members that were willing to enter into an arrangement with the Fund.

Mr. Arias said that the staff paper on the legal considerations of provisioning clearly showed that provisioning could be used only when there was a legitimate expectation that a member would not repay the Fund upon its withdrawal from the institution. Moreover, the Fund already had ample reserves; hence, there was no need to consider any type of provisioning. Provisioning and an increase in reserves might not meet identical goals, but provisioning would add to the burden of debtor countries. Any resort to provisioning would therefore be unacceptable.

The Fund had shown that it was able to deal with the problem of overdue payments, Mr. Arias remarked. The Executive Board had already taken many steps to safeguard the Fund's income position. For example, it had increased the Fund's reserves. The Executive Board should approach with caution any proposal to strengthen the Fund's financial position. The Fund was a unique institution that conducted a delicate task within the framework of the international economy, and it should not act precipitously or use commercial concepts in conducting its unique operations.

The Executive Board should not respond to the economic imbalances of certain countries by changing Fund procedures that had proved to be successful, Mr. Arias considered. The Fund was capable of correcting the problems that kept members' economies from growing.

It would be difficult to judge whether or not a loss was probable, Mr. Arias remarked. Experience showed that each member with overdue payments to the Fund intended to repay the institution. Its membership was the heart of the Fund, and the Executive Board should not lose faith in the willingness of members to support the institution.

Mr. Zecchini recalled that the staff had mentioned that the resources that would be set aside for provisioning could be used to provide financing to members. He wondered whether the same conclusion was applicable to the use of reserves for provisioning.

The Treasurer replied that, in terms of the Fund's liquidity, provisioning and reserves were identical.

Mr. Sengupta remarked that the Treasurer's comment underscored the fact that reserves would perform all the functions of provisioning.

Mr. Dallara said that he was not convinced that reserves would perform all the functions of provisioning. A change in the amount of reserves would not send a signal in an accounting sense about the probability of loss. Moreover, increasing reserves in response to a probable loss could overstate the Fund's net equity position.

The Treasurer commented that the staff had not suggested in EBS/86/82 that the function of reserves was identical to the function of provisioning. In response to Mr. Zecchini's question he had said that reserves and provisioning were identical in the context of the Fund's liquidity. Reserves resulted from a surplus of income over expenditure, while provisioning was an expense item that might lead to an income deficit. There could not be an increase in reserves in the absence of an income surplus. Provisioning could be introduced without a reduction in reserves.

The Chairman remarked that building up reserves at a rate that was linked to an internal procedure for judging the probability of loss would be similar to provisioning.

Mr. Sengupta said that the staff had noted in EBS/86/82 that reserves and provisioning could protect the Fund against loan losses. Reserves were increased as a result of a net income surplus, and provisioning would require the application of a charge, but the functions of each in protecting against a probable loss would be the same, especially if the financing for provisioning could be made available to members under arrangements with the Fund.

Mr. Nimatallah commented that in the commercial world reserves strengthened the net worth of institutions and could be used to finance operational deficits while provisioning was for a specific purpose and was used only when the need for it arose. A provision against a probable loss could be eliminated when the probable loss no longer existed. Reserves were maintained indefinitely. It was much easier to agree to eliminate a provision than to agree to reduce a high level of reserves.

Mr. Foot said that he wondered whether he was correct in assuming that the concept of net equity had no application in the context of liquidation within the Fund. In the event of liquidation, obligations would be discharged and any surplus would be distributed among the membership.

The Treasurer responded that Mr. Foot's understanding was correct.

The Chairman commented that conceivably the reserve target could be increased in order to protect the Fund against probable loss. The decision to increase reserves for that purpose would require the Fund to reach the same judgments that would be required if a provision were to be introduced.

Mr. Nimatallah said that in principle he agreed with the Chairman. However, there might be some difficulty in the timing of the increase in reserves. If provisioning was required in, say, the third or fourth month of the financial year, the Fund might not have the flexibility to increase its net income target immediately. In addition, it might be difficult to respond appropriately when the need for reserves to cover a probable loss ceased to exist. In that event, the Fund would have to decide what to do with the reserves that had been accumulated to cover the probable loss.

The Chairman remarked that he suspected that the same kinds of problems with lags and timing that Mr. Nimatallah had described in the context of accumulating reserves might well arise in the context of provisioning.

The Treasurer commented that if the Fund concluded that there was a probable loss involving a member with total outstanding repurchase obligations of, say SDR 100 million, the Fund could decide to provision SDR 20 million each year over a five-year period. Accordingly, the Fund would have an expense item for provisioning of SDR 20 million in its annual expense statement. The consequence of that expense for the Fund's reserves would depend on all the other elements of the Fund's income and expense statement. It was for that reason that, as Mr. Dallara had noted, there could be a larger addition to reserves in any given year than had been intended at the beginning of the year if there was excess net income. Alternatively the Fund could decide to add SDR 20 million to its reserves each year as a provision against the probable loss. That decision would require the Fund to add SDR 20 million to its reserves to have the same protection that would be afforded by an expenditure item of SDR 20 million; under the provisioning option, the Fund would not be required to increase reserves by SDR 20 million. Indeed, the Fund could run a deficit or, more realistically, could run down its reserves.

The Chairman said that in commenting on the difference between accumulating reserves or establishing a provision he had assumed that the policy concerning the accumulation of reserves would remain constant and that there would be an addition to reserves specifically to cover the probable loss.

Mr. Nimatallah considered that there were a number of important reasons to consider provisioning at the present stage. First, while the Fund was not a commercial institution, it was a financial institution and had to report its financial position accurately. Overdue obligations were increasing, and the average length of those obligations was growing. Moreover, there was evidence that some of the countries concerned were not taking appropriate steps to strengthen their economies and enhance their capacity to repay their debt. The Fund was suffering a loss of income and a deterioration in its liquidity and possibly in its credibility. Hence, the main question at hand was whether the Fund faced a probable loss of some of its assets. Apparently there was a judgmental factor in answering that question. In its paper on the legal considerations concerning provisioning the staff had mentioned that a probability that a loss could arise had to be determined in connection with withdrawal by a member and with a clear expression of repudiation by the member of all of its obligations to the Fund. The paper also said that provision could be made against that risk even before the effective withdrawal of the member. That explanation was neither practical nor realistic, as it was based on a loss of value of the Fund's holdings of currencies. The staff had concluded that the nonfulfillment of the maintenance of value obligation reduced the value of the Fund's holdings but did not reduce the value of the Fund's assets because the Fund had a claim for the difference on the member. In other words, the Fund was supposed to collect from the member a claim that constituted the difference between the value of the holdings and the value of the assets of the Fund. In fact, the Fund could not collect anything from the member concerned. As a result, the legal explanation of the circumstances in which provisioning would be appropriate was not helpful. The fundamental point that should be taken into account was that the currency of the countries in arrears could not be used to help other members; the total amount of net usable resources of the Fund was smaller than would otherwise be the case as long as overdue obligations were not settled.

The easiest solution to the problem of overdue obligations was to concede that the volume of resources that were actually available for lending to members was smaller than the figure reported in the Fund's financial statements, Mr. Nimatallah continued. However, that approach was not helpful to members that wished to use the Fund's resources and did not provide an accurate picture of the Fund's financial position for those who wished to monitor that position.

A close look at the list of members with arrears to the Fund suggested that there was sufficient ground to expect a probable loss, Mr. Nimatallah remarked. He hoped that he would prove to be wrong, but he suspected that probable losses would result from the overdue obligations of Kampuchea, Viet Nam, Guyana, and Liberia.

The time was ripe to initiate a process toward initiating a structured and comprehensive approach to the assessment of probable material loss, Mr. Nimatallah said. His comments were based on the assumption that the Executive Board was convinced that the Fund was facing a probable loss, and that even without any writing down or writing off of Fund assets a financial set-aside in the form of either an increase in reserves or provisioning was needed.

The World Bank management had recommended the adoption of a provisioning mechanism, Mr. Nimatallah noted. Since the Fund and the World Bank were similar in many respects, there was merit in the Fund deciding to adopt a provisioning mechanism. It was true that the Fund did not deal with commercial lenders, but it was also true that both the Fund and the World Bank relied ultimately on the financial support of their member governments.

Some other Executive Directors apparently preferred an increase in reserves to the establishment of provisions in response to the growing arrears problem, Mr. Nimatallah commented. He doubted whether an increase in reserves would be the best course of action at the present stage. The current volume of reserves of SDR 1 billion and the present rate of increase in reserves were not sufficient to cover the potentially large amount of arrears. Total overdue and forthcoming obligations for those countries that were already in arrears to the Fund exceeded SDR 2.4 billion. Even if the Executive Board doubled the net income target to about 10 percent, it would take seven years to double the present level of reserves.

Moreover, Mr. Nimatallah went on, reserves were actually retained earnings. Although the reserves were inadequate, his authorities took them into account in deciding whether or not to lend to the Fund. Broadening the role of the Fund's reserves to include an allowance for loss of assets would require a substantial increase in the reserves. A role for reserves in countering a probable loss of assets could be established at a later stage, as part of a possible sequence of events in the event that the problem of arrears were to become both large and protracted. Provisioning should be the first step in dealing with the arrears. If provisions were found to be insufficient, a deficit in the Fund's income position would arise. At that stage, the Fund could resort to reserves to finance the deficit. That step would perhaps send a signal that the problem of arrears had taken on a systemic dimension necessitating the adoption of emergency measures by the membership. Provisions were after all more flexible than the procedure for increasing reserves; provisions could be increased and decreased as circumstances required.

Some might argue that provisioning would send the wrong signal, encouraging members with arrears not to repay the Fund, Mr. Nimatallah continued. Apparently that argument was based on the assumption that the countries concerned intended not to repay the Fund and were looking for an excuse to make the final decision not to repay. That argument was not convincing. If some countries already intended not to repay the Fund, provisioning would obviously be helpful to the Fund. If the countries intended to repay the Fund--as seemed to be the case--but were unable to do so, the argument that provisioning sent the wrong signal would not hold. In fact, by failing to take any steps to retrieve the arrears and to strengthen the Fund's financial position, the Fund would send the wrong signal.

A comprehensive approach to evaluating probable loss and a system of provisioning against such loss could be based on the following criteria, Mr. Nimatallah said: amounts that had been overdue for more than three years should be assessed as probable losses; and if the amounts were due from countries that were taking no action to adjust their economies and to improve their capacity to repay the Fund, the amounts should be provisioned at 100 percent. Management should be given the discretion automatically to introduce provisioning on the basis of those two criteria but should inform the Executive Board of its action on a lapse of time basis. Only amounts that had been in arrears for more than three years need be provisioned for--not the member's total arrears for its total outstanding obligations to the Fund. However, he had an open mind concerning the length of the period of overdue arrears that should qualify for coverage by provisioning and on the percentage of the amounts concerned that should be provisioned for. Those matters should be further explored in the next staff paper on provisioning.

The Fund would have a range of options in liquidating a provision against a probable loss, Mr. Nimatallah remarked. The assets that had been set aside for the provision could be used to cover new probable losses that existed at the time that a probable loss had ceased to exist. The assets could be redistributed to members that had helped to finance the provision, could be added to reserves, could be deemed as income for the coming fiscal year, or could be invested in the suspense account until they were needed again for provisioning, or a combination of some or all of those options. All those options could be examined in the next staff paper on provisioning.

Covering the costs of provisioning was the most difficult aspect of the issue, Mr. Nimatallah commented. It was unfortunate that the membership was placed in the difficult position of carrying an additional burden because a few members had failed to adopt serious policies to restore balance to their economies. For all practical purposes, at the present stage the membership had no choice but to share the burden of funding provisioning. His authorities had an open mind on burden sharing and would go along with any structure of funding to cover the costs.

As he had indicated on previous occasions, the members that were in arrears to the Fund could help to solve the problems that arrears caused, Mr. Nimatallah said. The only viable option for those countries was the adoption of comprehensive adjustment policies to bring the economies concerned back on a path of sustainable growth. In that connection, the recent introduction of the structural adjustment facility and the strengthened role of the World Bank as a catalyst of resources could help members with arrears to gain the resources that were needed to support comprehensive adjustment policies. In adopting the needed policies the members would encourage donors to support the countries' adjustment efforts. Meanwhile, it was important for the Fund to continue to stress the inclusion of preventive measures in future programs.

Mr. Zecchini stated that in considering provisioning against loan losses it was essential for Executive Directors to reach a clear understanding on two basic points--the nature of the risk for which provisioning was required, and the distinctive elements that might make a loan loss provision preferable to an increase in reserves. After those points had been clarified, the Executive Directors could approach the question of which instruments were the most appropriate ones for strengthening the Fund's financial position.

Commenting on the risks that were to be covered by provisioning, Mr. Zecchini said that it was apparent that for the first time in its history the Fund faced a substantial amount of overdue repurchases that could impair the exchange value of its subscribed assets. The noncompliance could be attributed to financial and nonfinancial factors. The nonfinancial involved the so-called country risk that represented a new and worrying development in the Fund's experience with arrears.

Whatever the reasons for overdue obligations, the main issue at hand was whether the Fund might incur a loss on a loan to a member, Mr. Zecchini went on. In that connection, it was important to stress that the Fund was essentially a cooperative institution that made loans in the form of an exchange of assets among countries through the Fund's intermediation. Therefore, a loss could emerge only in the ultimate stage of that process of exchange of assets, namely, when a member withdrew from the Fund and did not settle its obligations on the terms requested, assuming for the sake of the present discussion that the extreme of the liquidation of the Fund need not be taken into account. Accordingly, the possibility that the Fund might incur a loss on a loan to a member was based on the probability that the member would withdraw from the Fund and would not settle its overdue obligations. When standard statistical measures of risk were applied, bearing in mind that there had never been a case in which a member had not eventually settled its obligations to the Fund, the conclusion was that the probability of a loss was extremely low. The International Accounting Standards Committee had concluded that provisioning was needed only when a contingent loss was probable, and that "probable" should be synonymous with "likely." At the same time, when there was only a reasonable or slight possibility that a loss would occur, provisioning was not called for. On the basis of available information he would be reluctant to conclude that there was a probable loss of a loan in the context of the Fund. However, the probability of an impairment of the Fund's assets--rather than a material loss--remained and over the previous year had been increasing in direct proportion to the rise in arrears. That probability called for additional measures to protect the Fund's assets from hidden erosion, and it was in that context that it would be useful to examine a possible loan loss provision. He doubted whether such a provision was necessary, as it was not clearly advantageous in comparison with an adjustment in the reserve growth target.

A loan loss provision was aimed at sheltering the income and reserves of an institution from the effects of a probable loss, Mr. Zecchini continued. However, he doubted whether in the Fund's case a loss was legally permissible or was probable from a statistical viewpoint. Moreover, the question arose why the Fund should shelter its income or reserves. The Fund differed from any banking institution; it was a nonprofit, cooperative association whose income was realized and retained almost exclusively for the purpose of protecting its assets by allowing a build-up of its reserves. The reserves served as a protection against both excess operational or administrative expenditures over revenue and an impairment or material loss of assets. In fact, the Fund's reserves performed all the functions of a loan loss provision, as there was no room in the Fund to aim at paying dividends out of earnings or to shelter reserves in order to safeguard the equity base; those stockmarket notions did not fit the characteristics of the Fund.

Some might argue that the advantage of a loan loss provision over reserves was the accounting transparency that would result from a more accurate statement of the Fund's financial position with the use of a loan loss provision, but that advantage had to be weighed against possible disadvantages, Mr. Zecchini commented. While loan loss provisions might be used only to cover losses stemming from nonpayment of a loan's principal, the Fund's reserves might be used to cover losses stemming from any source, including a failure to pay interest. In addition, if the introduction of a loan loss provision did not result in a corresponding reduction in reserve increases, the overall cost of a provision and an increase in reserves would be higher than the standard approach of accelerating the rate of reserve growth. Furthermore, the establishment of a loan loss provision could send a wrong signal, namely, that the Fund was seriously considering the possibility of having to write off loans, something that would not be consistent with the nature of the Fund and its credit transactions. Provisioning could give the mistaken impression that the Fund attached relatively less importance to obtaining the repayment of long overdue debt; that impression could have negative effects on the Fund's effort to recover the debt.

There was no significant comparative advantage in establishing a mechanism for provisioning in addition to the reserve mechanism, since the reserve mechanism could perform the functions of provisioning, Mr. Zecchini stated. A loan loss provision could be justified in the context of a burden sharing mechanism under which a provision would be financed by contributions from all members and would permit a reduction in the reserve accumulation target and consequently in the rate of charge. However, it was his understanding that there were legal and other difficulties in applying that approach.

It was important to consider the instruments that could be used to cope with a possible impairment of the Fund's assets, Mr. Zecchini continued. In that connection, it must be recognized that a more comprehensive and structured approach to the evaluation of that impairment was required. The lengthy and difficult process of reaching a consensus on such a judgment for each country with overdue purchases should be avoided. An automatic rule would be preferable and more effective. For example, the Fund could establish the time period that would have to lapse after a declaration of ineligibility before the Fund could presume that a situation of asset impairment had occurred and before the Fund would have to draw the necessary consequences from that established presumption. The presumption would trigger the taking of protective measures that would affect only the reserve accumulation target. A special ad hoc reserve could be created and added to the general reserves. The special character of that reserve would be derived only from the particular method that was used to determine its size. The special reserve might be set up or annually increased by an amount equivalent to a fraction of the total volume of outstanding overdue obligations of a member for which a presumption of asset impairment had been made. Any excess of ad hoc reserves that might emerge could be either shifted to general reserves or used for other purposes, such as providing relief to the countries that had financed the special reserve. Any decision on the size and funding of an ad hoc reserve should be taken in light of the decision on burden sharing. Additions to reserves in response to a possible impairment of the Fund's assets could not and should not be financed exclusively by members that were using the Fund's resources.

The Executive Directors agreed to continue their discussion in the afternoon.

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LEO VAN HOUTVEN
Secretary